Department of Finance

2007-03114/

News Release

Immediate release

Ottawa, December 28, 2006
2006-091

Canada's New Government Releases Proposals to Improve the Taxation of Financial Institutions

The Honourable Jim Flaherty, Minister of Finance, today announced proposals to improve the taxation of financial institutions by better aligning the current tax rules with new accounting standards set out by the Accounting Standards Board that came into effect as of October 1, 2006.

"Canada's New Government is acting to make our tax system simpler and fairer," said Minister Flaherty. "The proposals I am putting forward today will reduce the compliance burden on financial institutions and improve the economic efficiency of the tax system by improving the measurement of income and capital for tax purposes."

The proposals relate to the mark-to-market properties (in particular, specified debt obligations) held by all financial institutions, policy reserves that are deductible by insurance corporations in computing income for tax purposes, and the minimum tax for life insurance corporations resident in Canada. These proposals would be broadly revenue-neutral.

Details are being released to provide financial institutions and their advisors with information on the proposed changes in advance of the draft legislation that will be released for public comment in 2007.

The attached backgrounder provides further details on the proposed measures.

For further information, media may contact:

Eric Richer
Press Secretary
Office of the Minister of Finance
613-996-7861

David Gamble
Media Relations
Department of Finance
613-996-8080

www.fin.gc.ca

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Backgrounder

Tax Treatment of Mark-to-Market Properties

The Income Tax Act (Act) has specific rules for mark-to-market properties of financial institutions, which include specified debt obligations (SDOs) held by those financial institutions in circumstances where the financial institution is an investment dealer or the obligation has been carried at market value in the financial statements of the financial institution since the obligation was acquired. Where SDOs are mark-to-market properties, each year's increase or decrease in value of the obligations is included in computing the financial institution's income for the year. Where SDOs are not mark-to-market properties, the gains or losses on the disposition of SDOs (e.g., a bond) are spread over the remaining term of the SDO.

It is proposed that all SDOs held by financial institutions be treated as mark-to-market properties in the case where the SDOs are required by generally accepted accounting principles to be carried on the financial statements of the financial institution at their fair market value. Financial institutions holding SDOs and that are affected by these changes will be permitted to spread evenly the effect of these changes on their income for tax purposes over a five-year transition period. These changes will apply to all financial institutions as defined under section 142.2 of the Act and be effective for taxation years that begin after October 1, 2006.

Changes in Policy Reserves of Insurance Corporations

Policy reserves of insurance corporations will generally increase as a result of the new accounting standards, as the policy reserves of insurance corporations are generally linked to the yield on assets that support them. This could result in a significant increase in the policy reserves that are deductible under paragraph 20(7)(c) of the Act in the case of property and casualty insurance corporations and under paragraph 138(3)(a) of the Act in the case of life insurance corporations.

The increases or decreases in policy reserves of insurance corporations attributable to the changes in accounting standards will not be permitted in the year in which the accounting changes first take effect. Instead, those increases or decreases will be spread evenly over a five-year period starting in the first year in which the accounting changes take effect. These changes will be effective for taxation years that begin after October 1, 2006.

Policy Reserves for Life Insurance Policies Issued Before 1996

Policy reserves deductible by life insurance corporations under paragraph 138(3)(a) of the Act and prescribed by section 1404 of the Income Tax Regulations (Regulations) in respect of life insurance policies issued after 1995 are based on the policy reserves reported on the financial statements of the life insurance corporation. For life insurance policies issued prior to 1996, the policy reserves for tax purposes under paragraph 138(3)(a) are based on the rules set out in section 1401 of the Regulations.

It is proposed that, for life insurance policies issued prior to 1996, the policy reserves be based on the reserves reported on the financial statements. The increases or decreases in reserves resulting from this change will not be included or deducted from income for tax purposes in the year in which these changes are first implemented. Instead, the increases or decreases will be spread evenly over a five-year period starting in the year in which these changes are first implemented. These changes will be effective for taxation years that begin after October 1, 2006.

Taxable Capital Employed in Canada Under the Minimum Tax

The minimum tax on financial institutions applies to banks, life insurance corporations, trust companies and mortgage loan companies. As a result of changes proposed in the 2006 budget, the tax will be modified as of July 1, 2006, to a tax of 1.25 per cent on taxable capital employed in Canada in excess of $1 billion. The taxable capital employed in Canada generally follows capital and long-term debt reported on the financial statements of financial institutions.

However, life insurance corporations are required to add a "reserve adjustment" to their taxable capital employed in Canada under section 190.11 in Part VI of the Income Tax Act. This reserve adjustment adds the amount, if any, by which the policy reserves reported on the financial statements exceed the maximum policy reserves reported for tax purposes. This reserve adjustment is no longer required and is being repealed. This change will apply to taxation years of financial institutions that begin after October 1, 2006.